

## **Senate Bill No. 5**

### **CHAPTER 610**

An act to amend Sections 17152, 18042, 18510, 18601, 23732, 23801, 23802, 23806, and 24611 of, and to add Sections 17275.6, 17731.5, 18037.5, 19136.4, 19365, 23800.5, 23802.5, 23804, 23804.5, 23813, 24954, and 24990.4 to, the Revenue and Taxation Code, relating to taxation, to take effect immediately, tax levy.

[Approved by Governor October 1, 1997. Filed  
with Secretary of State October 3, 1997.]

#### **LEGISLATIVE COUNSEL'S DIGEST**

SB 5, Lockyer. Income and bank and corporation taxes: gains: "S corporation."

The Personal Income Tax Law provides for the manner in which taxable gains are to be recognized upon the disposition of property, including real property that is the principal residence of the taxpayer.

This bill would, as provided, conform these provisions, with respect to the recognition of gain upon the disposition of a principal residence, to recent changes in federal income tax law.

The Bank and Corporation Tax Law, in specified conformity to federal income tax law, provides that an election to be treated as an "S corporation" may be made by a small business corporation, as defined, that, among other things, does not have more than 35 shareholders.

This bill would provide additional conformity to federal income tax law by providing, among other things, that the corporation not have more than 75 shareholders for purposes of that requirement and by providing other "S corporation" changes relating to electing small business trusts as shareholders, post-death qualification for certain trusts, financial institutions permitted to hold safe-harbor debt, termination of elections of "S" status, authorization of "S" subsidiaries, treatment of distributions during loss years, carryover of disallowed losses and deductions under at-risk rules, treatment of inherited stock, treatment of gain from subdivided real estate, and "S corporation" status for certain financial institutions and exempt organizations, as provided.

The bill would permit an "S corporation" to apply to transfer an overpayment of estimated tax to the personal income tax accounts of its shareholders, in accordance with specified procedures. This bill would also increase the tax rate applicable to "S corporations."

This bill would provide additional conformity to federal income tax law with respect to sales of stock to employee stock ownership plans or certain cooperatives.

This bill would take effect immediately as a tax levy; however, except as otherwise provided, its provisions would apply to taxable years beginning on or after January 1, 1997.

*The people of the State of California do enact as follows:*

SECTION 1. Section 17152 of the Revenue and Taxation Code is amended to read:

17152. (a) For sales and exchanges before May 7, 1997, and on or after July 1, 1998, Section 121 of the Internal Revenue Code, relating to one-time exclusion of gain from sale of principal residence by individual who has attained age 55, is modified to additionally include both of the following:

(1) The dollar amount of the exclusion in Section 121(b) of the Internal Revenue Code shall be the same as allowed for federal purposes as determined by the taxpayer's filing status for federal purposes even though the taxpayer is prohibited from filing a joint return pursuant to Section 18521. However, in no instance shall the total amount excludable for the sale of a principal residence exceed the maximum amount allowed by Section 121(b) of the Internal Revenue Code.

(2) The three-year period in Section 121(a)(2) of the Internal Revenue Code shall be reduced by the period of the taxpayer's service, not to exceed 18 months, in the Peace Corps during the five-year period ending on the date of the sale or exchange.

(b) For sales and exchanges on and after May 7, 1997, and on or before June 30, 1998, Section 121 of the Internal Revenue Code, relating to one-time exclusion of gain from sale of principal residence by an individual who has attained age 55, shall not apply and in lieu of that section subdivisions (c) to (h), inclusive, shall apply. References in the Internal Revenue Code to Section 121 of the Internal Revenue Code shall instead be treated as a reference to subdivision (c) of this section.

(c) Gross income shall not include gain from the sale or exchange of property if, during the five-year period ending on the date of the sale or exchange, the property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating two years or more. The two-year period shall be reduced by the period of the taxpayer's service, not to exceed 18 months, in the Peace Corps during the five-year period ending on the date of the sale or exchange.

(d) (1) The amount of gain excluded from gross income under subdivision (c) with respect to any sale or exchange shall not exceed two hundred fifty thousand dollars (\$250,000).

(2) Paragraph (1) shall be applied by substituting five hundred thousand dollars (\$500,000) for two hundred fifty thousand dollars (\$250,000) if all of the following conditions are met:

(A) A husband and wife make a joint return for the taxable year of the sale or exchange of the property.

(B) Either spouse meets the ownership requirements of subdivision (c) with respect to the property.

(C) Both spouses meet the use requirements of subdivision (c) with respect to the property.

(D) Neither spouse is ineligible for the benefits of subdivision (c) with respect to the property by reason of paragraph (3).

(3) (A) Subdivision (c) shall not apply to any sale or exchange by the taxpayer if, during the two-year period ending on the date of the sale or exchange, there was any other sale or exchange by the taxpayer to which subdivision (c) applied.

(B) Subparagraph (A) shall be applied without regard to any sale or exchange before May 7, 1997.

(4) If the taxpayer is prohibited from filing a joint return pursuant to Section 18521, subparagraph (A) of paragraph (2) shall nevertheless be treated as being satisfied if the taxpayer files a joint return for federal income tax purposes for the same taxable year. However, in no instance shall the total amount excludable from gross income under subdivision (c) with respect to any sale or exchange exceed five hundred thousand dollars (\$500,000).

(e) (1) In the case of a sale or exchange that is subject to this subdivision in accordance with paragraph (2), the ownership and use requirements of subdivision (c) shall not apply and paragraph (3) of subdivision (d) shall not apply, but the amount of gain excluded from gross income under subdivision (c) with respect to the sale or exchange shall not exceed the amount that bears the same ratio to the amount that would be so excluded if those requirements had been met, as the shorter of the following two periods bears to two years:

(A) The aggregate periods, during the five-year period ending on the date of the sale or exchange, during which the property has been owned and used by the taxpayer as the taxpayer's principal residence.

(B) The period after the date of the most recent prior sale or exchange by the taxpayer to which subdivision (c) applied and before the date of the sale or exchange.

(2) This subdivision shall apply to any sale or exchange if:

(A) Subdivision (c) would not, but for this subdivision, apply to the sale or exchange by reason of either of the following:

(i) A failure to meet the ownership and use requirements of subdivision (c).

(ii) Paragraph (3) of subdivision (d).

(B) The sale or exchange is by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances.

(f) (1) For purposes of this section, in the case of an unmarried individual whose spouse is deceased on the date of the sale or exchange of property, the period the unmarried individual owned the property shall include the period the deceased spouse owned the property before death.

(2) For purposes of this section:

(A) In the case of an individual holding property transferred to that individual in a transaction described in Section 1041(a) of the Internal Revenue Code, the period the individual owns the property shall include the period the transferor owned the property.

(B) Solely for purposes of this section, an individual shall be treated as using property as that individual's principal residence during any period of ownership while that individual's spouse or former spouse is granted use of the property under a divorce or separation instrument, as defined in Section 71(b)(2) of the Internal Revenue Code.

(3) For purposes of this section, if the taxpayer holds stock as a tenant-stockholder, as defined in Section 216 of the Internal Revenue Code, in a cooperative housing corporation, as defined in Section 216 of the Internal Revenue Code:

(A) The holding requirements of subdivision (c) shall be applied to the holding of that stock.

(B) The use requirements of subdivision (c) shall be applied to the house or apartment which the taxpayer was entitled to occupy as the stockholder.

(4) (A) For purposes of this section, the destruction, theft, seizure, requisition, or condemnation of property shall be treated as the sale of the property.

(B) In applying Section 1033 of the Internal Revenue Code, relating to involuntary conversions, the amount realized from the sale or exchange of property shall be treated as being the amount determined without regard to this section, reduced by the amount of gain not included in gross income pursuant to this section.

(C) If the basis of the property sold or exchanged is determined, in whole or in part, under Section 1033(b) of the Internal Revenue Code, relating to basis of property acquired through involuntary conversion, then the holding and use by the taxpayer of the converted property shall be treated as holding and use by the taxpayer of the property sold or exchanged.

(5) Subdivision (c) shall not apply to so much of the gain from the sale of any property as does not exceed the portion of the depreciation adjustments, as defined in Section 1250(b)(3) of the Internal Revenue Code, attributable to periods after May 6, 1997, with respect to that property.



(6) In the case of a taxpayer who becomes physically or mentally incapable of self-care, and owns property and uses the property as the taxpayer's principal residence during the five-year period described in subdivision (c) for periods aggregating at least one year, the taxpayer shall be treated as using the property as the taxpayer's principal residence during any time during the five-year period in which the taxpayer owns the property and resides in any facility, including a nursing home, licensed by a state or political subdivision to care for an individual in the taxpayer's condition.

(7) In the case of any sale or exchange, for purposes of this section:

(A) The determination of whether an individual is married shall be made as of the date of the sale or exchange.

(B) An individual legally separated from his or her spouse under a decree of divorce or of separate maintenance shall not be considered as married.

(8) For purposes of this section:

(A) At the election of the taxpayer, this section shall not fail to apply to the sale or exchange of an interest in a principal residence by reason of that interest being a remainder interest in the residence, but this section shall not apply to any other interest in that residence which is sold or exchanged separately.

(B) Subparagraph (A) shall not apply to any sale to, or exchange with, any person who bears a relationship to the taxpayer which is described in Section 267(b) or 707(b) of the Internal Revenue Code.

(g) If a taxpayer has, at any time, made an election for federal purposes under Section 121(f) of the Internal Revenue Code, as amended by Public Law 105-34, not to have Section 121 of the Internal Revenue Code, as amended by Public Law 105-34, apply to a sale or exchange, subdivision (c) of this section shall not apply to that sale or exchange, a separate election for state purposes shall not be allowed under paragraph (3) of subdivision (e) of Section 17024.5, the federal election shall be binding for purposes of this part, and that election shall be treated as an election to include in gross income for purposes of this part all the gain from the sale or exchange of property, including that amount which, but for that election, would have been excluded from income under subdivision (c) of this section.

(h) For purposes of this section, in the case of property the acquisition of which by the taxpayer resulted under Section 1034 of the Internal Revenue Code, as in effect on the day before the date of enactment of the act adding this subdivision, in the nonrecognition of any part of the gain realized on the sale or exchange of another residence, in determining the period for which the taxpayer has owned and used the property as the taxpayer's principal residence, there shall be included the aggregate periods for which the other residence, and each prior residence taken into account under Section



1223(7) of the Internal Revenue Code in determining the holding period of the property, had been so owned and used.

(i) For sales and exchanges on or after May 7, 1997, and on or before June 30, 1998, the provisions that require a report under Section 18643 are modified to only require a copy of the federal return required to be filed with the Secretary of the Treasury under Section 6045(e) of the Internal Revenue Code, as amended by Public Law 105-34.

SEC. 2. Section 17275.6 is added to the Revenue and Taxation Code, to read:

17275.6. For taxable years beginning on or after January 1, 1998, Section 170(e)(1) of the Internal Revenue Code, relating to certain contributions of ordinary income and capital gain property, is modified to provide that for purposes of applying Section 170(e)(1) of the Internal Revenue Code in the case of a charitable contribution of stock in an S corporation, rules similar to the rules of Section 751 of the Internal Revenue Code, relating to unrealized receivables and inventory items, shall apply in determining whether gain on the stock would have been long-term capital gain if the stock were sold by the taxpayer.

SEC. 3. Section 17731.5 is added to the Revenue and Taxation Code, to read:

17731.5. (a) Section 641 of the Internal Revenue Code, relating to imposition of tax, is modified as follows:

(1) For purposes of this part, both of the following shall apply:

(A) The portion of any electing small business trust which consists of stock in one or more “S corporations” shall be treated as a separate trust.

(B) The amount of the tax imposed by this part on that separate trust shall be determined with the modifications of paragraph (2).

(2) For purposes of paragraph (1), the modifications are the following:

(A) The amount of the tax imposed by subdivision (e) of Section 17041 shall be determined by using the highest rate of tax applicable to an individual under subdivision (a) of Section 17041.

(B) The credit allowed under subdivision (b) of Section 17733 shall be zero.

(C) The only items of income, loss, deduction, or credit to be taken into account are the following:

(i) The items required to be taken into account under Section 1366 of the Internal Revenue Code, relating to passthrough of items to shareholders, as modified for purposes of this part and Part 11.

(ii) Any gain or loss from the disposition of stock in an “S corporation.”

(iii) Administrative expenses to the extent allocable to items described in clauses (i) and (ii).



No deduction or credit shall be allowed for any amount not described in this paragraph, and no item described in this paragraph shall be apportioned to any beneficiary.

(D) No amount shall be allowed under Section 1211(b)(1) or (2) of the Internal Revenue Code, relating to limitation on capital losses.

(3) For purposes of determining the amount of the tax imposed by this part on the portion of any electing small business trust not treated as a separate trust under paragraph (1), and the distributable net income of the entire trust, the items referred to in subparagraph (C) of paragraph (2) shall be excluded. Except as provided in the preceding sentence, this section shall not affect the taxation of any distribution from the trust.

(4) If a portion of an electing small business trust ceases to be treated as a separate trust under paragraph (1), any carryover or excess deduction of the separate trust which is referred to in Section 642(h) of the Internal Revenue Code, relating to unused loss carryovers and excess deductions on termination available to beneficiaries, shall be taken into account by the entire trust.

(5) For purposes of this section, the term “electing small business trust” has the meaning given to that term by subdivision (d) of Section 23800.5.

(b) This section shall apply to taxable years beginning on or after January 1, 1997.

SEC. 4. Section 18037.5 is added to the Revenue and Taxation Code, to read:

18037.5. For sales and exchanges after May 6, 1997, and on or before June 30, 1998:

(a) Section 1034 of the Internal Revenue Code, relating to rollover of gain on sale of principal residence, shall not apply.

(b) References in Sections 56(e), 163(h), 280A(d), 464(f), 1033(h), 1274(c), and 7872(f) of the Internal Revenue Code, and paragraph (3) of subdivision (e) of Section 18662 of the Revenue and Taxation Code, to Section 1034 of the Internal Revenue Code, shall instead be treated as a reference to Section 17152 of the Revenue and Taxation Code.

(c) Section 216(e) of the Internal Revenue Code is modified by substituting “such dwelling unit is used as his or her principal residence (within the meaning of Section 17152)” for the phrase “such exchange qualifies for nonrecognition of gain under Section 1034(f).”

(d) References in Sections 512(a), 1016(a), and 1223(7) of the Internal Revenue Code to Section 1034 of the Internal Revenue Code shall be treated as a reference to that section as in effect on the day before the date of the enactment of the act adding this section.

(e) Section 1038(e) of the Internal Revenue Code, relating to principal residences, shall be modified to provide that, under regulations prescribed by the Secretary of the Treasury under



Section 1038 of the Internal Revenue Code, unless the Franchise Tax Board prescribes otherwise, Section 1038(b), (c), and (d) of the Internal Revenue Code shall not apply to the reacquisition of property and, for purposes of applying Section 17152, the resale of that property shall be treated as a part of the transaction constituting the original sale of the property, if both of the following apply:

(1) Section 1038(a) of the Internal Revenue Code applies to a reacquisition of real property with respect to the sale of which gain was not recognized under Section 17152.

(2) Within one year after the date of reacquisition of the property by the seller, that property is resold by him or her.

(f) Section 1250(d)(7) of the Internal Revenue Code, relating to disposition of principal residence, shall not apply.

(g) Section 1250(e)(3) of the Internal Revenue Code, relating to principal residence, shall not apply.

SEC. 5. Section 18042 of the Revenue and Taxation Code is amended to read:

18042. (a) Section 1042 of the Internal Revenue Code, relating to sales of stock to employee stock ownership plans or certain cooperatives, shall apply to taxable years beginning on or after January 1, 1996.

(b) For taxable years beginning on or after January 1, 1998, Section 1042 of the Internal Revenue Code, relating to sales of stock to employee stock ownership plans or certain cooperatives, is modified to provide that the term “domestic corporation” shall instead mean “domestic C corporation.”

SEC. 6. Section 18510 of the Revenue and Taxation Code is amended to read:

18510. For purposes of Sections 18501, 18505, and 18521, gross income shall be computed without regard to the exclusion provided for in Section 17152.

SEC. 7. Section 18601 of the Revenue and Taxation Code is amended to read:

18601. (a) Except as provided in subdivision (b) or (c), every taxpayer subject to the tax imposed by Part 11 (commencing with Section 23001) shall, within two months and 15 days after the close of its income year, transmit to the Franchise Tax Board a return in a form prescribed by it, specifying for the income year, all the facts as it may by rule, or otherwise, require in order to carry out this part. A tax return, disclosing net income for any income year, filed pursuant to Chapter 2 (commencing with Section 23101) or Chapter 3 (commencing with Section 23501) of Part 11 shall be deemed filed pursuant to the proper chapter of Part 11 for the same income period, if the chapter under which the return is filed is determined erroneous.





(b) In the case of cooperative associations described in Section 24404, returns shall be filed on or before the 15th day of the ninth month following the close of its income year.

(c) In the case of taxpayers required to file a return for a short period under Section 24634, the due date for the short period return shall be the same as the due date of the federal tax return that includes the net income of the taxpayer for that short period, or the due date specified in subdivision (a) if no federal return is required to be filed that would include the net income for that short period.

(d) For income years beginning on or after January 1, 1997, each “S corporation” required to file a return under subdivision (a) for any income year shall, on or before the day on which the return for the income year was filed, furnish each person who is a shareholder at any time during the income year a copy of the information shown on the return.

(e) For taxable or income years beginning on or after January 1, 1997:

(1) A shareholder of an “S corporation” shall, on the shareholder’s return, treat a Subchapter S item in a manner that is consistent with the treatment of the item on the corporate return.

(2) (A) In the case of any Subchapter S item, paragraph (1) shall not apply to that item if both of the following occur:

(i) Either of the following occurs:

(I) The corporation has filed a return but the shareholder’s treatment of the item on the shareholder’s return is or may be inconsistent with the treatment of the item on the corporate return.

(II) The corporation has not filed a return.

(ii) The shareholder files with the Franchise Tax Board a statement identifying the inconsistency.

(B) A shareholder shall be treated as having complied with clause (ii) of subparagraph (A) with respect to a Subchapter S item if the shareholder does both of the following:

(i) Demonstrates to the satisfaction of the Franchise Tax Board that the treatment of the Subchapter S item on the shareholder’s return is consistent with the treatment of the item on the schedule furnished to the shareholder by the corporation.

(ii) Elects to have this paragraph apply with respect to that item.

(3) In any case described in subclause (I) of clause (i) of subparagraph (A) of paragraph (2), and in which the shareholder does not comply with clause (ii) of subparagraph (A) of paragraph (2), any adjustment required to make the treatment of the items by the shareholder consistent with the treatment of the items on the corporate return shall be treated as arising out of a mathematical error and assessed and collected under Section 19051.

(4) For purposes of this subdivision, the term “Subchapter S item” means any item of an “S corporation” to the extent provided by regulations that, for purposes of Part 10 (commencing with Section

17001) or this part, the item is more appropriately determined at the corporation level than at the shareholder level.

(5) The penalties imposed under Article 7 (commencing with Section 19131) of Chapter 4 shall apply in the case of a shareholder's negligence in connection with, or disregard of, the requirements of this section.

SEC. 8. Section 19136.4 is added to the Revenue and Taxation Code, to read:

19136.4. (a) No addition to tax shall be made under Section 19136 for any period before April 16, 1998, with respect to any underpayment of an installment for the 1997 taxable year, to the extent that the underpayment was created or increased by Section 1, 4, or 6 of the act adding this section.

(b) The Franchise Tax Board shall adopt procedures, forms, and instructions necessary to implement this section in a reasonable manner.

SEC. 9. Section 19365 is added to the Revenue and Taxation Code, to read:

19365. (a) (1) A corporation electing to be treated as an "S corporation" under Chapter 4.5 (commencing with Section 23800) of Part 11, may file an application for the transfer of an overpayment with respect to payments of estimated tax for income years beginning in 1997, to the personal income tax accounts of its shareholders. An application under this subdivision shall not constitute a claim for credit or refund.

(2) An application under this subdivision shall be verified in the manner prescribed by Section 18621 in the case of the taxpayer, and shall be filed in the manner and form prescribed by the Franchise Tax Board. The application shall set forth all of the following:

(A) The amount the "S corporation" estimates as its tax liability under this part for the taxable year, which shall not be less than the greater of  $1\frac{1}{2}$  percent of its net income or the applicable minimum franchise tax.

(B) The amount and date of the estimated tax paid during the income year.

(C) For each shareholder affected, his or her name, social security account number, address, percent of ownership and any changes in percent of ownership for the "S corporation's" income year, and amount of each overpayment to be transferred, and the date the amount was paid.

(D) Any other information for purposes of carrying out this section as may be required by the Franchise Tax Board.

(b) (1) Within a period of 45 days from the date on which an application for a transfer is filed under subdivision (a), the Franchise Tax Board shall make, to the extent it deems practicable in that period, a limited examination of the application to discover omissions and errors therein, and shall determine the final amount of the

transfers upon the basis of the application and the examination, except that the Franchise Tax Board may disallow, without further action, any application which it finds contains material omissions or errors which it deems cannot be corrected within the 45-day period.

(2) The Franchise Tax Board, within the 45-day period referred to in paragraph (1), may credit the amount of the overpayment against any liability on the part of the taxpayer under Part 11.

(3) In the event the amount available for transfer is less than requested by the taxpayer, the overpayment amount shall be allocated among the shareholders on a pro rata basis based on the percent of ownership stated on the application.

(4) For purposes of Part 10 (commencing with Section 17001), Part 11 (commencing with Section 23001), and this part, the transferred amounts shall be treated as if they had been estimated tax payments paid by the respective shareholders on the date originally paid by the corporation.

(5) No application under subdivision (a) shall be allowed unless the amount to be transferred equals or exceeds five hundred dollars (\$500).

(6) Each “S corporation” which files an application for transfer of overpayments under subdivision (a) shall furnish to each person who is a shareholder at any time during the income year a statement showing amounts and dates of the overpayments being transferred to that person’s personal income tax account.

SEC. 10. Section 23732 of the Revenue and Taxation Code is amended to read:

23732. Section 512 of the Internal Revenue Code, relating to unrelated business taxable income, shall apply, except as otherwise provided.

(a) Section 512(a)(2) of the Internal Revenue Code, relating to special rules for foreign organizations, shall not be applicable.

(b) Section 512(a)(3) of the Internal Revenue Code, relating to special rules applicable to certain organizations, shall be modified as follows:

(1) The reference to Section 501(c)(7) of the Internal Revenue Code, relating to clubs organized for pleasure, recreation, and other nonprofitable purposes, shall be modified to refer to Section 23701g.

(2) The reference to Section 501(c)(9) of the Internal Revenue Code, relating to voluntary employees’ beneficiary associations, shall be modified to refer to Section 23701i.

(3) The reference to Section 501(c)(17) of the Internal Revenue Code, relating to trusts providing for payment of supplemental unemployment compensation benefits, shall be modified to refer to Section 23701n.

(4) The reference to Section 501(c)(20) of the Internal Revenue Code, relating to qualified group legal services plans, shall be modified to refer to Section 23701q.



(c) Section 512(b)(10) of the Internal Revenue Code, relating to charitable contributions, shall be modified to provide that such deductions shall not exceed 5 percent of the unrelated business taxable income, rather than 10 percent.

(d) For income years beginning on or after January 1, 1998, Section 512 of the Internal Revenue Code, relating to unrelated business taxable income, is modified to provide that:

(1) If an organization described in paragraph (2) of subdivision (b) of Section 23800.5 holds stock in an “S corporation,” both of the following shall apply:

(A) The interest shall be treated as an interest in an unrelated trade or business.

(B) Notwithstanding any other provision of Part III of Chapter 1A of the Internal Revenue Code, Part 10 (commencing with Section 17001), Part 10.2 (commencing with Section 18401), or this part, all items of income, loss, or deduction taken into account under Section 1366(a) of the Internal Revenue Code, and any gain or loss on the disposition of the stock in the S corporation, shall be taken into account in computing the unrelated business taxable income of the organization.

(2) Except as provided in regulations, for purposes of paragraph (1), the basis of any stock acquired by purchase, within the meaning of Section 1012 of the Internal Revenue Code, shall be reduced by the amount of any dividends received by the organization with respect to the stock.

SEC. 11. Section 23800.5 is added to the Revenue and Taxation Code, to read:

23800.5. (a) For income years beginning on or after January 1, 1997, Section 1361(b)(1)(A) of the Internal Revenue Code, relating to small business corporations defined, shall be modified by substituting “have more than 75 shareholders,” in lieu of “have more than 35 shareholders” specified therein.

(b) For income years beginning on or after January 1, 1998:

(1) Section 1361(b)(1)(B) of the Internal Revenue Code, relating to small business corporations, is modified to provide that a small business corporation may not have as a shareholder a person (other than an estate, a trust described in Section 1361(c)(2) of the Internal Revenue Code, or an organization described in paragraph (2)), who is not an individual.

(2) Section 1361(c) of the Internal Revenue Code, relating to special rule for applying subsection (b), is modified to provide that, for purposes of Section 1361(b)(1)(B) of the Internal Revenue Code, an organization that is described in Section 401(a) of the Internal Revenue Code or Section 23701d of this code, and exempt from taxation under Section 23701, may be a shareholder in an “S corporation.”



(c) For income years beginning on or after January 1, 1997, Section 1361(c)(2) of the Internal Revenue Code, relating to certain trusts permitted as shareholders, is modified as follows:

(1) (A) The phrase “60-day period” is modified to read “2-year period” each place it appears in Section 1361(c)(2)(A)(ii) and (iii) of the Internal Revenue Code.

(B) The last sentence in Section 1361(c)(2)(A)(ii) of the Internal Revenue Code shall not apply.

(2) Section 1361(c)(2)(A) of the Internal Revenue Code is modified to provide that an electing small business trust may be a shareholder.

(3) Section 1361(c)(2)(B) of the Internal Revenue Code is modified to provide that in the case of an electing small business trust, each potential current beneficiary of the trust shall be treated as a shareholder. However, if for any period there is no potential current beneficiary of the trust, the trust shall be treated as the shareholder during that period.

(4) For purposes of this subdivision, the term “potential current beneficiary” means, with respect to any period, any person who at any time during that period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust. If a trust disposes of all of the stock which it holds in an “S corporation,” then, with respect to that corporation, the term “potential current beneficiary” does not include any person who first met the requirements of the preceding sentence during the 60-day period ending on the date of the disposition.

(d) For income years beginning on or after January 1, 1997, and before January 1, 1998, Section 1361 of the Internal Revenue Code, relating to S corporation defined, is modified to provide as follows:

(1) For purposes of this subdivision:

(A) Except as provided in subparagraph (B), the term “electing small business trust” means any trust if all of the following apply:

(i) The trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, or (III) an organization described in Section 170(c)(2), (3), (4), or (5) of the Internal Revenue Code which holds a contingent interest and is not a potential current beneficiary.

(ii) No interest in the trust was acquired by purchase.

(iii) An election under this subdivision applies to the trust.

(B) The term “electing small business trust” shall not include either of the following:

(i) Any qualified Subchapter S trust (as defined in Section 1361(d)(3) of the Internal Revenue Code) if an election under Section 1361(d)(2) of the Internal Revenue Code applies to any corporation the stock of which is held by the qualified Subchapter S trust.

(ii) Any trust exempt from tax under Part 10 (commencing with Section 17001) or this part.

(C) For purposes of subparagraph (A), the term “purchase” means any acquisition if the basis of the property acquired is determined under Section 1012 of the Internal Revenue Code or Section 24912 of this code.

(2) For purposes of this subdivision, the term “potential current beneficiary” means, with respect to any period, any person who at any time during that period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust. If a trust disposes of all of the stock which it holds in an “S corporation,” then, with respect to that corporation, the term “potential current beneficiary” does not include any person who first met the requirements of this paragraph during the 60-day period ending on the date of the disposition.

(3) (A) An election made by the trustee under Section 1361 of the Internal Revenue Code to be an electing small business trust for federal purposes shall be treated for purposes of this part as an election made by the trustee under this subdivision and a separate election under paragraph (3) of subdivision (e) of Section 23051.5 shall not be allowed. Any election made shall apply to the taxable year of the trust for which made and to all subsequent taxable years of the trust, unless revoked with the consent of the Franchise Tax Board.

(B) No election under this subdivision shall be allowed unless the trustee has made the election under Section 1361 of the Internal Revenue Code to be an electing small business trust for federal purposes.

(e) For income years beginning on or after January 1, 1998, Section 1361 of the Internal Revenue Code, relating to “S corporation” defined, is modified to provide as follows:

(1) For purposes of this subdivision:

(A) Except as provided in subparagraph (B), the term “electing small business trust” means any trust if all of the following apply:

(i) The trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, or (III) an organization described in Section 170(c)(2), (3), (4), or (5) of the Internal Revenue Code.

(ii) No interest in the trust was acquired by purchase.

(iii) An election under this subdivision applies to the trust.

(B) The term “electing small business trust” shall not include any of the following:

(i) Any qualified Subchapter S trust (as defined in Section 1361(d)(3) of the Internal Revenue Code) if an election under Section 1361(d)(2) of the Internal Revenue Code applies to any corporation the stock of which is held by the qualified Subchapter S trust.

(ii) Any trust exempt from tax under Part 10 (commencing with Section 17001) or this part.

(C) For purposes of subparagraph (A), the term “purchase” means any acquisition if the basis of the property acquired is determined under Section 1012 of the Internal Revenue Code or Section 24912 of this code.

(2) (A) An election made by the trustee under Section 1361 of the Internal Revenue Code to be an electing small business trust for federal purposes shall be treated for purposes of this part as an election made by the trustee under this subdivision, and a separate election under paragraph (3) of subdivision (e) of Section 23051.5 shall not be allowed. Any election made shall apply to the taxable year of the trust for which made and to all subsequent taxable years of the trust, unless revoked with the consent of the Franchise Tax Board.

(B) No election under this subdivision shall be allowed unless the trustee has made the election under Section 1361 of the Internal Revenue Code to be an electing small business trust for federal purposes.

(f) For income years beginning on or after January 1, 1997, Section 1361(b) of the Internal Revenue Code, relating to small business corporations, is modified to provide as follows:

(1) For purposes of Part 10 (commencing with Section 17001), Part 10.2 (commencing with Section 18401), and this part:

(A) A corporation that is a qualified Subchapter S subsidiary shall not be treated as a separate corporation, except as provided in subparagraph (B).

(B) There is hereby imposed a tax annually in an amount equal to the applicable amount specified in paragraph (1) of subdivision (d) of Section 23153 on a qualified Subchapter S subsidiary that is incorporated under the laws of this state, qualified to transact intrastate business in this state pursuant to Chapter 21 (commencing with Section 2100) of Division 1 of Title 1 of the Corporations Code, or doing business in this state.

(C) Every qualified Subchapter S subsidiary described in subparagraph (B) shall be subject to the tax imposed under subparagraph (B) from the earlier of the date of incorporation, qualification, or commencing to do business in this state, until the effective date of dissolution or withdrawal as provided in Section 23331, or, if later, the date the corporation ceases to do business in this state.

(D) (i) All activities, assets, liabilities, including liability for the tax imposed under this subdivision, and items of income, deduction, and credit of a qualified Subchapter S subsidiary shall be treated as activities (including for purposes of Section 23101), assets, liabilities, and such items, as the case may be, of the “S corporation.”

(ii) The tax imposed under this subdivision shall be due and payable on the 15th day of the fourth month of the income year of the “S corporation.”

(2) For purposes of this subdivision, the term “qualified Subchapter S subsidiary” means any domestic corporation that is not an ineligible corporation, as defined in Section 1361(b)(2) of the Internal Revenue Code, if both of the following apply:

(A) One hundred percent of the stock of the corporation is held by the S corporation.

(B) The “S corporation” has in effect a valid election to treat the corporation as a qualified Subchapter S subsidiary for federal purposes.

(3) (A) An election made by the “S corporation” under Section 1361(b)(2) of the Internal Revenue Code to treat the corporation as a qualified Subchapter S subsidiary for federal purposes shall be treated for purposes of this part as an election made by the “S corporation” under this subdivision and a separate election under paragraph (3) of subdivision (e) of Section 23051.5 shall not be allowed.

(B) No election under this subdivision shall be allowed unless the “S corporation” has made the election under Section 1361(b)(2) of the Internal Revenue Code to treat the corporation as a qualified Subchapter S subsidiary for federal purposes.

(4) For purposes of Part 10 (commencing with Section 17001), Part 10.2 (commencing with Section 18401), or this part, if any corporation that was a qualified Subchapter S subsidiary ceases to meet the requirements of paragraph (2), that corporation shall be treated as a new corporation acquiring all of its assets, and assuming all of its liabilities, immediately before that cessation from the “S corporation” in exchange for its stock.

(5) If a corporation’s status as a qualified Subchapter S subsidiary terminates, the corporation and any successor corporation shall not be treated as having in effect a valid election under subparagraph (B) of paragraph (2), or be eligible to make an election under Section 1362(a) of the Internal Revenue Code, before its fifth income year which begins after the first income year for which the termination is effective, unless the Franchise Tax Board consents to the election.

(6) Section 1361(b)(2)(A) of the Internal Revenue Code shall not apply.

(g) For income years beginning on or after January 1, 1997, Section 1361(b)(2)(B) of the Internal Revenue Code, relating to ineligible corporation defined, shall not apply and in lieu thereof, for purposes of Section 1361(b)(1) of the Internal Revenue Code, Part 10 (commencing with Section 17001), Part 10.2 (commencing with Section 18401), and this part, the term “ineligible corporation” shall include a savings and loan association, bank, or financial corporation which uses the reserve method of accounting for bad debts described in Section 24348.

(h) For income years beginning on or after January 1, 1997, Section 1361(c)(5)(B)(iii) of the Internal Revenue Code, relating to





straight debt defined, is modified to include in the list of creditors contained therein, a person that is actively and regularly engaged in the business of lending money.

(i) For income years beginning on or after January 1, 1997, Section 1361(c)(6) of the Internal Revenue Code shall not apply.

SEC. 12. Section 23801 of the Revenue and Taxation Code is amended to read:

23801. (a) (1) A corporation may not elect to be treated as an “S corporation” unless it has in effect for federal purposes a valid election under Section 1362(a) of the Internal Revenue Code for the same year.

(2) For income years beginning in 1987, the following shall apply:

(A) A corporation that has in effect a valid federal election for the income year beginning in 1987, shall be deemed to have elected to be treated as an “S corporation” for purposes of this part, unless that corporation elects on its return to continue to be treated as a “C corporation” for purposes of this part.

(B) A corporation to which subparagraph (A) applies, but is not required to file a return under this part, may elect to be treated as a “C corporation” for purposes of this part in the form and in the manner as the Franchise Tax Board may prescribe.

(C) A corporation that is deemed to have elected to be treated as an “S corporation” under subparagraph (A) shall, for purposes of applying the provisions of Section 1374 of the Internal Revenue Code, relating to tax imposed on certain built-in gains, and Section 1375 of the Internal Revenue Code, relating to tax imposed on passive investment income, be deemed to have made the election to be treated as an “S corporation” on the same date as the date of its federal election under Section 1362(a) of the Internal Revenue Code.

(3) For income years beginning in 1988 or 1989, the following shall apply:

(A) A corporation that had in effect a valid federal election for the preceding year, but was a “C corporation” for purposes of this part for that preceding year, may elect to be treated as an “S corporation” for purposes of this part by making an election in accordance with the provisions of Section 1362 of the Internal Revenue Code in the form and in the manner as the Franchise Tax Board may prescribe.

(B) A corporation that did not have in effect a valid federal election for the preceding year and that makes a federal election for the income year under Section 1362(a) of the Internal Revenue Code shall be deemed to have made an election to be treated as an “S corporation” for purposes of this part on the same date as the date of its federal election, unless that corporation elects on its return to continue to be treated as a “C corporation” for purposes of this part.

(C) A corporation to which subparagraph (B) applies, but is not required to file a return under this part, may elect to be treated as

a “C corporation” for purposes of this part in a form and manner as the Franchise Tax Board may prescribe.

(D) A corporation that elects to be treated as an “S corporation” under subparagraph (A) for an income year beginning in 1988 shall, for purposes of applying the provisions of Section 1374 of the Internal Revenue Code, relating to tax imposed on certain built-in gains, and Section 1375 of the Internal Revenue Code, relating to tax imposed on passive investment income, be deemed to have made the election to be treated as an “S corporation” on the same date as the date of its federal election under Section 1362(a) of the Internal Revenue Code.

(4) For income years beginning on or after January 1, 1990, the following shall apply:

(A) An election under Section 1362(a) of the Internal Revenue Code, that is first effective for an income year beginning on or after January 1, 1990, shall be an election to which subdivision (e) of Section 23051.5 applies and shall be deemed to have been made for purposes of this part on the same date as the date of the federal election, unless the corporation files a California election under clause (ii) to be treated as a “C corporation” for purposes of this part.

(i) The federal “S” election shall be reported for purposes of this part in the form and manner as prescribed by the Franchise Tax Board no later than the last date allowed for filing the federal election under Section 1362(a) of the Internal Revenue Code for that income year.

(ii) The California election to be a “C corporation” may only be made by a corporation incorporated in California or qualified to do business in California and shall be made in the form and manner prescribed by the Franchise Tax Board no later than the last date allowed for filing the federal “S” election under Section 1362(a) of the Internal Revenue Code for that income year.

(B) A corporation that has in effect a valid election under Section 1362(a) of the Internal Revenue Code, but is a “C corporation” for purposes of this part, may elect to be treated as an “S corporation” by making an election in the form and manner as prescribed by the Franchise Tax Board at the time required for making an “S” election under Section 1362(a) of the Internal Revenue Code for that income year, unless prohibited from doing so by Section 1362(g) of the Internal Revenue Code, relating to election after termination.

(C) In the event a corporation which has in effect a valid election under Section 1362(a) of the Internal Revenue Code and is not doing business in California becomes subject to this part by qualifying to do business in California, the corporation is deemed to have made an election to be treated as an “S corporation” for the income year during which the corporation qualifies to do business in California, unless the corporation files a California election in accordance with clause (ii) to be treated as a “C corporation” for that income year.



(i) The federal “S” election shall be reported for purposes of this part within two and one-half months after qualifying to do business in California in the form and manner as prescribed by the Franchise Tax Board.

(ii) The California election to be a “C corporation” shall be made in the form and manner as prescribed by the Franchise Tax Board no later than the following:

(I) For an income year beginning in 1990, two and one-half months after qualifying to do business in California.

(II) For an income year beginning on or after January 1, 1991, the last date allowed for filing a federal “S” election under Section 1362(a) of the Internal Revenue Code for that income year.

(D) (i) A corporation that is not qualified to do business in California, but is treated as an “S corporation” for federal purposes, shall be treated as an “S corporation” for purposes of this part, and its shareholders shall be treated as shareholders of an “S corporation.”

(ii) If a corporation described in clause (i) elected to be treated as a “C corporation” under this section prior to its amendment by the act adding this paragraph during the 1989–90 Regular Session, that election shall be revoked for income years beginning on or after January 1, 1990. The corporation shall be treated as an “S corporation” for purposes of this part, and its shareholders shall be treated as shareholders of an “S corporation.”

(E) For purposes of this section, “qualified to do business in California” or “qualifying to do business in California” means incorporating or obtaining a certificate of qualification pursuant to the Corporations Code.

(F) For purposes of this section:

(i) A timely election to be treated as a “C corporation” shall be treated as a revocation and Section 1362(g) of the Internal Revenue Code, relating to election after termination, shall apply.

(ii) An untimely election to be treated as a “C corporation” shall be null and void and shall not be applied to either the current or any subsequent income year.

(5) For income years beginning on or after January 1, 1997, the provisions in paragraph (4) shall apply, subject to the following modifications:

(A) A corporation which elects “S corporation” status under the provisions of Section 1316 of the Small Business Job Protection Act of 1996 (P.L. 104-188) for federal purposes but which is not qualified to be an “S corporation” under subdivision (g) of Section 23800.5, shall not be an “S corporation” for purposes of Part 10 (commencing with Section 17001) and this part.

(B) (i) A corporation which becomes an “S corporation” for an income year beginning before January 1, 1997, under the provisions of Section 1305 of the Small Business Job Protection Act of 1996 (P.L. 104-188) for federal purposes, shall become an “S corporation” for

purposes of Part 10 (commencing with Section 17001) and this part for its first income year beginning on or after January 1, 1997, unless a timely election to continue as a “C corporation” is made.

(ii) For purposes of clause (i), an election shall be considered timely if made no later than the earlier of the date that is 180 days after the date of enactment of the act adding this paragraph or the due date, without regard to extensions, of the return for its first income year beginning on or after January 1, 1997.

(C) (i) A corporation which makes a valid federal election to be an “S corporation” during the period in 1997 before the date of enactment of the act adding this paragraph and which would not qualify to be an “S corporation” under this part on the date of the federal election shall become an “S corporation” for purposes of Part 10 (commencing with Section 17001) and this part for its first income year beginning on or after January 1, 1997, unless a timely election to continue as a “C corporation” is made.

(ii) For purposes of clause (i), an election shall be considered timely if made no later than the earlier of the date that is 180 days after the date of enactment of the act adding this paragraph or the due date, without regard to extensions, of the return for its first income year beginning on or after January 1, 1997.

(b) If a corporation subject to tax under this part elects to be treated as an “S corporation” and has one or more shareholders who are nonresidents of this state or is a trust with a nonresident fiduciary, each of the following shall be required:

(1) Each nonresident shareholder or fiduciary shall file with the return a statement of consent by that shareholder or fiduciary to be subject to the jurisdiction of the State of California to tax the shareholder’s pro rata share of the income attributable to California sources.

(2) An “S corporation” shall include in its return for each income year a list of shareholders in the form and in the manner prescribed by the Franchise Tax Board.

(3) Failure to meet the requirements of this subdivision shall be grounds for retroactive revocation by the Franchise Tax Board of the election pursuant to this chapter.

(c) Except as provided in subdivision (d), a corporation that makes a valid election to be treated as an “S corporation” for purposes of this part shall not be included in a combined report pursuant to Article 1 (commencing with Section 25101) of Chapter 17.

(d) (1) In cases where the Franchise Tax Board determines that the reported income or loss of a group of commonly owned or controlled corporations (within the meaning of Section 25105), which includes one or more corporations electing to be treated as an “S corporation” under Chapter 4.5 (commencing with Section 23800), does not clearly reflect income (or loss) of a member of that



group or represents an evasion of tax by one or more members of that group, and the Franchise Tax Board determines that the comparable uncontrolled price method prescribed by regulations pursuant to Section 482 of the Internal Revenue Code cannot practically be applied, the Franchise Tax Board may, in lieu of other methods prescribed by regulations pursuant to Section 482 of the Internal Revenue Code, apply methods of unitary combination, pursuant to Article 1 (commencing with Section 25101) of Chapter 17, to properly reflect the income or loss of the members of the group.

(2) The application of the provisions of this subdivision shall not affect the election of any corporation to be treated as an “S corporation.”

(e) The tax for a “C corporation” for a short year shall be determined in accordance with Chapter 13 (commencing with Section 24631), in lieu of Section 1362(e)(5) of the Internal Revenue Code.

(f) (1) A termination of a federal election pursuant to Section 1362(d) of the Internal Revenue Code, that is not an inadvertent termination pursuant to Section 1362(f) of the Internal Revenue Code, shall simultaneously terminate the “S corporation” election for purposes of Part 10 (commencing with Section 17001) and this part.

(2) A federal termination by revocation shall be effective for purposes of this part and shall be reported to the Franchise Tax Board in the form and manner prescribed by the Franchise Tax Board no later than the last date allowed for filing federal termination for that year under Section 1362(d) of the Internal Revenue Code.

(3) A corporation which is qualified to do business in California and has in effect a valid “S” election under Section 1362(a) of the Internal Revenue Code, may revoke its “S” election for purposes of this part without revoking its federal election. The revocation for purposes of this part shall be made by providing a written notification to the Franchise Tax Board in the form and manner prescribed by the Franchise Tax Board which includes the California corporation number and meets the requirements of Section 1362(d)(1) of the Internal Revenue Code.

(g) For income years beginning on or after January 1, 1990, if a corporation, which has in effect a valid “S” election under Section 1362(a) of the Internal Revenue Code, fails to make a “C corporation” election under clause (ii) of subparagraphs (A) and (C) of paragraph (4) of subdivision (a) or to terminate by revocation under paragraph (3) of subdivision (f), the corporation shall be treated as an “S corporation” pursuant to subparagraph (A) of paragraph (4) of subdivision (a).

(h) For income years beginning on or after January 1, 1997, for purposes of subparagraph (F) of paragraph (4) of subdivision (a) of this section and Section 1362(g) of the Internal Revenue Code, relating to election after termination, any termination under Section

1362(d) of the Internal Revenue Code or election to be treated as a “C corporation” under subparagraph (A) or (C) of paragraph (4) of subdivision (a), or to terminate by revocation under paragraph (3) of subdivision (f) in an income year beginning before January 1, 1997, shall not be taken into account.

(i) For income years beginning on or after January 1, 1997:

(1) Section 1362(b) of the Internal Revenue Code is modified to provide that if an election under Section 1362(a) of the Internal Revenue Code is made for any income year, determined without regard to Section 1362(b)(3) of the Internal Revenue Code, after the date prescribed by this subdivision for making the election for the income year or no election is made for any income year, and the Franchise Tax Board determines that there was reasonable cause for the failure to timely make the election, the Franchise Tax Board may treat that election as timely made for the income year, and Section 1362(b)(3) of the Internal Revenue Code shall not apply.

(2) Section 1362(f) of the Internal Revenue Code, relating to inadvertent terminations, is modified to provide that notwithstanding circumstances resulting in the ineffectiveness or termination of an election under Section 1362(a) of the Internal Revenue Code, a corporation shall be treated as an “S corporation” during the period specified by the Franchise Tax Board if all of the following apply:

(A) The election by any corporation was not effective for the income year for which made, determined without regard to Section 1362(b)(2) of the Internal Revenue Code, by reason of a failure to meet the requirements of Section 1361(b) of the Internal Revenue Code or to obtain shareholder consents, or was terminated under Section 1362(d)(2) or (3) of the Internal Revenue Code.

(B) The Franchise Tax Board determines that the circumstances resulting in the ineffectiveness or termination of the election were inadvertent.

(C) No later than a reasonable period of time after discovery of the circumstances resulting in that ineffectiveness or termination, steps were taken so that the corporation is a small business corporation, or to acquire the required shareholder consents.

(D) The corporation, and each person who was a shareholder in the corporation at any time during the period specified pursuant to this subdivision, agrees to make the adjustments, consistent with the treatment of the corporation as an “S corporation,” as may be required by the Franchise Tax Board with respect to that period.

(j) Section 1362(d)(3) of the Internal Revenue Code, relating to termination where passive investment income exceeds 25 percent of gross receipts for three consecutive years and corporation has Subchapter C earnings and profits, is modified to provide that if an “S corporation” holds stock in a “C corporation” meeting the requirements of Section 1504(a)(2) of the Internal Revenue Code,

the term “passive investment income” shall not include dividends for that “C corporation” to the extent the dividends are attributable to the earnings and profits of that “C corporation” derived from the active conduct of a trade or business.

SEC. 13. Section 23802 of the Revenue and Taxation Code is amended to read:

23802. (a) Section 1363(a) of the Internal Revenue Code, relating to the taxability of an “S corporation,” shall not be applicable.

(b) Corporations qualifying under this chapter shall continue to be subject to the taxes imposed under Chapter 2 (commencing with Section 23101) and Chapter 3 (commencing with Section 23501), except as follows:

(1) (A) The tax imposed under Section 23151 or 23501 shall be imposed at a rate of  $1\frac{1}{2}$  percent rather than the rate specified in those sections.

(B) For income years beginning on or after January 1, 1997, the following tax rates shall be substituted for the “ $1\frac{1}{2}$  percent” rate specified by subparagraph (A):

(i) One and six-tenths percent for income years beginning on or after January 1, 1997, and before January 1, 1998.

(ii) One and sixty-five hundredths percent for income years beginning on or after January 1, 1998, and before January 1, 1999.

(iii) One and seven-tenths percent for income years beginning on or after January 1, 1999, and before January 1, 2000.

(iv) One and six-tenths percent for income years beginning on or after January 1, 2000.

(2) In the case of an “S corporation” which is also a financial corporation, the rate of tax specified in paragraph (1) shall be increased by the excess of the rate imposed under Section 23183 over the rate imposed under Section 23151.

(c) An “S corporation” shall be subject to the minimum franchise tax imposed under Section 23153.

(d) (1) For purposes of subdivision (b), an “S corporation” shall be allowed a deduction under Section 24416 or 24416.1 (relating to net operating loss deductions), but only with respect to losses incurred during periods in which the corporation had in effect a valid election to be treated as an “S corporation” for purposes of this part.

(2) Section 1371(b) of the Internal Revenue Code, relating to denial of carryovers between “C years” and “S years,” shall apply for purposes of the tax imposed under subdivision (b), except as provided in paragraph (1).

(3) The provisions of this subdivision shall not affect the amount of any item of income or loss computed in accordance with the provisions of Section 1366 of the Internal Revenue Code, relating to pass-thru items to shareholders.

(4) For purposes of subdivision (b) of Section 17276, relating to limitations on loss carryovers, losses passed through to shareholders

of an “S corporation,” to the extent otherwise allowable without application of that subdivision, shall be fully included in the net operating loss of that shareholder and then that subdivision shall be applied to the entire net operating loss.

(e) For purposes of computing the taxes specified in subdivision (b), an “S corporation” shall be allowed a deduction from income for built-in gains and passive investment income for which a tax has been imposed under this part in accordance with the provisions of Section 1374 of the Internal Revenue Code, relating to tax imposed on certain built-in gains, or Section 1375 of the Internal Revenue Code, relating to tax imposed on passive investment income.

(f) For purposes of computing taxes imposed under this part, as provided in subdivision (b)—

(1) An “S corporation” shall compute its deductions for amortization and depreciation in accordance with the provisions of Part 10 (commencing with Section 17001) of Division 2.

(2) The provisions of Section 465 of the Internal Revenue Code, relating to limitation of deductions to the amount at risk, shall be applied in the same manner as in the case of an individual.

(3) (A) The provisions of Section 469 of the Internal Revenue Code, relating to limitations on passive activity losses and credits, shall be applied in the same manner as in the case of an individual. For purposes of the tax imposed under Section 23151 or 23501, as modified by this section, material participation shall be determined in accordance with Section 469(h) of the Internal Revenue Code, relating to certain closely held “C corporations” and personal service corporations.

(B) For purposes of this paragraph, the “adjusted gross income” of the “S corporation” shall be equal to its “net income,” as determined under Section 24341 with the modifications required by this subdivision, except that no deduction shall be allowed for contributions allowed by Section 24357.

(4) The exclusion provided under Section 18152.5 shall not be allowed to an “S corporation.”

(g) The provisions of Section 1363(d) of the Internal Revenue Code, relating to recapture of LIFO benefits, shall be modified for purposes of this part to refer to Section 19102 in lieu of Section 6601 of the Internal Revenue Code.

SEC. 14. Section 23802.5 is added to the Revenue and Taxation Code, to read:

23802.5. (a) For income years beginning on or after January 1, 1997, Section 1366(a)(1) of the Internal Revenue Code, relating to determination of shareholder’s tax liability, is modified to apply to the final taxable year of a trust or estate which terminates before the end of the corporation’s income year.

(b) For income years beginning on or after January 1, 1997, Section 1366(d)(1)(A) of the Internal Revenue Code, relating to



losses and deductions that cannot exceed shareholder's basis in stock and debt, is modified to additionally provide that the adjusted basis of a shareholder's stock in the S corporation is to be decreased by distributions by the corporation that were not includable in the income of the shareholder by reason of Section 1368 of the Internal Revenue Code.

(c) For income years beginning on or after January 1, 1997, Section 1366(d)(3) of the Internal Revenue Code, relating to carryover of disallowed losses and deductions to post-termination transition period, is modified to provide that to the extent that any increase in adjusted basis described in Section 1366(d)(3)(B) of the Internal Revenue Code would have increased the shareholder's amount at risk under Section 465 if the increase had occurred on the day preceding the commencement of the post-termination transition period, rules similar to the rules described in Section 1366(d)(3)(A) to (C), inclusive, of the Internal Revenue Code shall apply to any losses disallowed by reason of Section 465(a) of the Internal Revenue Code.

SEC. 15. Section 23804 is added to the Revenue and Taxation Code, to read:

23804. For decedents dying after December 31, 1996, Section 1367(b) of the Internal Revenue Code, relating to adjustments to basis of stock of shareholders, etc., is modified to provide as follows:

(a) If any person acquires stock in an "S corporation" by reason of the death of a decedent or by bequest, devise, or inheritance, Section 691 of the Internal Revenue Code shall be applied with respect to any item of income of the "S corporation" in the same manner as if the decedent had held directly the decedent's pro rata share of that item.

(b) The basis determined under Section 1014 of the Internal Revenue Code of any stock in an "S corporation" shall be reduced by the portion of the value of the stock that is attributable to items constituting income in respect of the decedent.

SEC. 16. Section 23804.5 is added to the Revenue and Taxation Code to read:

23804.5. For income years beginning on or after January 1, 1997:

(a) Section 1368(d) of the Internal Revenue Code, relating to certain adjustments taken into account, is modified to provide that in the case of any distribution made during any income year, the adjusted basis of the stock shall be determined with regard to the adjustments provided in Section 1367(a)(1) of the Internal Revenue Code.

(b) Section 1368(e)(1) of the Internal Revenue Code, relating to accumulated adjustments account, is modified to provide as follows:

(1) In applying Section 1368 of the Internal Revenue Code to distributions made during any income year, the amount in the accumulated adjustments account as of the close of the income year



shall be determined without regard to any net negative adjustment for that income year.

(2) For purposes of paragraph (1), the term “net negative adjustment” means, with respect to any income year, the excess, if any, of the reduction in the account for the income year, other than for distributions, over the increase in that account for that income year.

(3) Section 1368(e)(1)(A) of the Internal Revenue Code shall be modified to take into account the provisions of this subdivision.

(4) Section 1368(e)(1)(A) of the Internal Revenue Code shall be modified to refer to Section 1367(a)(2) of the Internal Revenue Code in lieu of Section 1367(b)(2)(A) of the Internal Revenue Code.

SEC. 17. Section 23806 of the Revenue and Taxation Code is amended to read:

23806. (a) For income years beginning on or after January 1, 1997, Section 1371(a) of the Internal Revenue Code, relating to application of Subchapter C rules, is modified to provide that, except as otherwise provided in this part or Title 26 of the United States Code, and except to the extent inconsistent with this chapter or Subchapter S of Chapter 1 of Subtitle A of the Internal Revenue Code, Subchapter C of Chapter 1 of Subtitle A of the Internal Revenue Code shall apply to an “S corporation” and its shareholders.

(b) Notwithstanding subdivisions (a) and (e) of Section 23051.5, an election under Section 338 of the Internal Revenue Code, relating to certain stock purchases treated as asset acquisitions, for federal purposes shall be treated as an election for purposes of this part and a separate election under paragraph (3) of subdivision (e) of Section 23051.5 shall not be allowed.

(c) Section 1371(d) of the Internal Revenue Code shall not be applicable.

SEC. 18. Section 23813 is added to the Revenue and Taxation Code, to read:

23813. (a) For income years beginning on or after January 1, 1997, Section 1377(a)(2) of the Internal Revenue Code, relating to pro rata share, is modified to provide as follows:

(1) As prescribed in regulations, if any shareholder terminates the shareholder’s interest in the corporation during the income year and all affected shareholders and the corporation agree to the application of this subdivision, Section 1377(a)(1) of the Internal Revenue Code shall be applied to the affected shareholders as if the income year consisted of two income years the first of which ends on the date of the termination.

(2) For purposes of subdivision (a) and Section 1377 of the Internal Revenue Code, the term “affected shareholders” means the shareholder whose interest is terminated and all shareholders to whom that shareholder has transferred shares during the income year. If that shareholder has transferred shares to the corporation, the

term “affected shareholders” shall include all persons who are shareholders during the income year.

(b) For income years beginning on or after January 1, 1997, Section 1377(b) of the Internal Revenue Code, relating to post-termination transition period, is modified to provide as follows:

(1) The term “post-termination transition period” includes the 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer which follows the termination of the corporation’s election and which adjusts a Subchapter S item of income, loss, or deduction of the corporation arising during the S period, as defined in Section 1368(e)(2) of the Internal Revenue Code.

(2) Section 1377(b)(2) of the Internal Revenue Code, relating to determination defined, is modified to provide that for purposes of paragraph (1) and Section 1377(b)(1) of the Internal Revenue Code, the term “determination” means either of the following:

(A) (i) A determination as defined in Section 1313(a) of the Internal Revenue Code.

(ii) A decision by the State Board of Equalization that has become final.

(iii) A closing agreement made under Article 6 (commencing with Section 19441) of Chapter 6 of Part 10.2.

(iv) A final disposition by the Franchise Tax Board of a claim for refund.

(B) An agreement between the corporation and the Secretary of the Treasury or the Franchise Tax Board that the corporation failed to qualify as an “S corporation.”

SEC. 19. Section 24611 of the Revenue and Taxation Code is amended to read:

24611. (a) Section 404(k) of the Internal Revenue Code, relating to dividends paid deduction, shall apply to income years beginning on or after January 1, 1996.

(b) For income years beginning on or after January 1, 1998, Section 404(a)(9) of the Internal Revenue Code, relating to certain contributions to employee ownership plans, is modified to provide that Section 404(a)(9) of the Internal Revenue Code shall not apply to an “S corporation.”

(c) For income years beginning on or after January 1, 1998, Section 404(k)(1) of the Internal Revenue Code, relating to deduction for dividends on certain employer securities, is modified to provide that the phrase “a corporation” shall read “a C corporation.”

SEC. 20. Section 24954 is added to the Revenue and Taxation Code, to read:

24954. (a) Section 1042 of the Internal Revenue Code, relating to sales of stock to employee stock ownership plans or certain cooperatives, shall apply to income years beginning on or after January 1, 1996.

(b) For income years beginning on or after January 1, 1998, the term “domestic corporation” shall mean “domestic C corporation.”

SEC. 21. Section 24990.4 is added to the Revenue and Taxation Code, to read:

24990.4. For income years beginning on or after January 1, 1997:

(a) Section 1237(a) of the Internal Revenue Code, relating to real property subdivided for sale, is modified to provide that the term “other than a corporation” in the material preceding Section 1237(a)(1) of the Internal Revenue Code shall instead mean “other than a C corporation.”

(b) Section 1237(a)(2)(A) of the Internal Revenue Code, relating to real property subdivided for sale, is modified to provide that an improvement shall be deemed to be made by the taxpayer if that improvement was made by an “S corporation” that included the taxpayer as a shareholder.

SEC. 22. (a) This act provides for a tax levy within the meaning of Article IV of the Constitution and shall go into immediate effect. However, unless otherwise specifically provided, the provisions of this act shall be applied to taxable years beginning on or after January 1, 1997.

(b) If a taxpayer has, at any time, made an election for federal purposes under Section 312(d)(2) of the Taxpayer Relief Act of 1997 (P.L. 105-34), relating to sales before date of enactment, or Section 312(d)(4) of that act, relating to binding contracts, to not have the amendments made by Section 312 of the Taxpayers Relief Act of 1997 (P.L. 105-34) apply to a sale or exchange, Sections 1, 4, and 6 of this act shall not apply to that sale or exchange, a separate election for state purposes shall not be allowed under paragraph (3) of subdivision (e) of Section 17024.5, and the federal election shall be binding for purposes of this part.

